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**IN THE**  
**Supreme Court of the United States**

**OCTOBER TERM, 1942.**

**No. 552**

**INTERSTATE TRANSIT LINES,**  
*Petitioner,*

**v.**

**GUY T. HELVERING, COMMISSIONER OF**  
**INTERNAL REVENUE,**  
*Respondent.*

**ON WRIT OF CERTIORARI TO THE CIRCUIT COURT**  
**OF APPEALS FOR THE EIGHTH CIRCUIT**

**REPLY BRIEF OF PETITIONER.**

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*To the Honorable Chief Justice and Associate Justices of  
the Supreme Court of the United States:*

**SUMMARY OF ARGUMENT IN REPLY.**

The question of consolidated returns is not involved and the legislative history on this subject is immaterial.

Respondent's argument that the deficit may reflect items not properly deductible from gross income is a new contention made here for the first time, and represents a departure from the theory on which the case was tried

and on which both tribunals below proceeded. The record does, however, contain evidence tending to prove that the deductions were proper as ordinary and necessary expenses. The single item of "bus rental," which respondent suggests should, if Stages is Interstate's agent, be eliminated from the computation, is also reflected in Interstate's gross income, so that if the agency relationship is given effect the items offset each other and Interstate's net income is not artificially reduced by an intercompany account, as respondent suggests.

Respondent concedes the "necessity;" and, the California operation being a part of Interstate's business enterprise, the expense of such California operation was "ordinary" as well. Especially is this true as to the interstate portion of the California carriage. Respondent's assertion that Interstate's business included neither interstate nor intrastate carriage in California conflicts with his own pleading, and is contrary to the assumption made by the court below and contrary to the evidence. His contention ignores realities. The fact is that Stages was but a part, and a small part, of a complete integrated bus transportation system.

The attempted distinction of the *Southern Pacific Company* and *Gulf Oil Corporation* cases on the ground that they were concerned with the question of pre-1913 versus post-1913 earnings ignores this Court's conclusions in each of these cases that what was the subsidiary's income had, because of considerations which are the same as those here urged on petitioner's behalf, already become the parent's income. Respondent's argument ignores the fact that, under *Lynch v. Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, if, because of such considerations, the income had not already become the parent's, a dividend out of such pre-March 1, 1913 income would if declared after that date have been taxable.

Respondent inconsistently asserts not only Stages' separate entity but the right, in same connection, in effect to disregard that entity, or at least treat it as of little significance, in considering the question of the effect of the contracts. His contention appears to be that because of the sole fact that one of the contracting parties was the other's only stockholder, the tax consequences of the contracts should be different from what they would be if the parties were entirely independent. There is no question of fraud nor is any challenge made to the allocation provided for by the contracts. Consistency in the matter of Stages' separate existence requires recognition of the contractual arrangement, which in effect was one for an agency, and strengthens the evidence establishing the agency.

Respondent's suggestion that the claimed deduction is bottomed on a "mere book entry" is not supported by the record, which on the contrary establishes that it represents a real economic expense. Both tribunals below proceeded on the assumption that the item is real, not a "mere book entry." The evidence establishes that such is the fact.

### **ARGUMENT.**

#### **No Question Involved of Any Attempt to File Consolidated Returns.**

(Numerals in Parentheses Refer to Pages of Transcript.)

Much of respondents' brief is devoted to a discussion of propositions not in controversy. Concededly mere stock ownership, which prior to 1934 would alone have entitled any two or more corporations to file consoli-

dated returns, did not in 1936 have that effect. Respondent's extended summary of the legislative history of the 1934 change in regard to consolidated returns amounts to no more than saying that it was the intent of Congress that every corporation (except railroads) file returns of and pay taxes on its own income. This proposition, which is not disputed by petitioner, does not, however, reach the problem in the present case. The statute is plain enough in this respect, and the legislative history adds nothing by way of aid to its construction. Neither a holding that payment of the deficit is an ordinary and necessary expense of the parent nor one that Stages is Interstate's agent (either as to all California business or as to the interstate portion only) can affect Stages' obligation to return *its* net income for taxation, and pay a tax thereon if any tax is due. Payment by Interstate of Stages' deficit automatically must be reflected in Stages' gross income. No question is involved here of any income which may escape tax, nor of duplicate deductions. Interstate does not claim that a consolidated return be permitted in spite of the statute. It is contending that it should pay a tax on *its net income only*, and that respondent is attempting to tax it on \$28,100.66 more of net income than it actually obtained. Respondent avoids discussing the unreality of treating Stages as anything but an agent, for a legitimate business purpose, of Interstate. The legislative history of the amendment abolishing the consolidated return privilege has nothing to do with this matter, and is beside the point.

**Analysis of Respondent's Argument That the Deficit May Not Have Resulted from Charges Deductible Otherwise from Gross Income.**

Although he admitted in his answer (13) that Stages' deficit was \$28,100.66, as alleged in the petition (4), respondent now, for the first time, advances the argument that the deficit may have resulted from improper charges.

Heretofore in this litigation there has been no question of this sort suggested, so that it is not surprising that the Board of Tax Appeals, as respondent states (Brief, p. 13), made no findings "respecting the nature or deductibility of the items that produced Stages' net operating loss." If respondent is correct in contending that the items going into the calculation of the deficit should be scrutinized (although this aspect of the matter was never in controversy, so far as the record discloses), then, in the interest of justice, the cause might well be remanded for appropriate findings on the subject, and, if necessary, for further evidence. The record in its present shape does, however, contain evidence tending to establish that the claimed deduction is correct in amount and reflects only proper items of deductions. Respondent's emphasis on this new proposition makes necessary some mention of the evidence on this branch of the case.

After suggesting (Brief, p. 11) the possibility that the deficit may have resulted from non-deductible items,<sup>1</sup> respondent refers specifically to the expense item "bus rental," and then says that "a principal could not directly claim a deduction for rent charged by him against his agent," in which connection he cites *Southern Pacific Co. v. Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142. Exhibit C (66, 67) shows a complete itemization of expenses, totaling \$211,470.59, of which "rent of equipment" appears to be the only item not of the kind that would involve cash payment to outside parties. Respondent is correct in pointing out that a mere inter-company charge

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1. Respondent suggests Federal income taxes as an example of such items. Taxes shown in the revenue statement (Exhibit C) are \$12,007.61. This is the amount reflected in the deficit. Taxes shown in the ledger account (Exhibit A), when added, come to \$14,739.98. The difference which is *not* reflected as a deduction, of \$2,732.37 may well have represented Stages' income taxes for prior years paid in 1936, although the record does not disclose what is the fact in this regard, except that a small item of back Federal income taxes shown in the ledger account supports for this inference.

would not, standing alone, constitute a proper factor in swelling the expense deductions, and therefore the deficit. But the argument proves too much. It also proves that the inclusion in Interstate's gross revenues of the corresponding "bus rental" item should not have been reflected in Interstate's net income.<sup>1</sup> The items eliminate one another.

1. Gross revenues allocated to Stages were \$183,365.60. This is shown on the first page of respondent's Exhibit C (66), which is a statement of revenues and expenses of Stages, Interstate, and another subsidiary (Interstate Transit Lines, Inc.) which is not involved here. This total of revenues includes \$12,073.76 of "bus rentals." Respondent refers to page 63 of the record, on which page there is shown his Exhibit A, which is the ledger account showing monthly totals of cash payments by Interstate for Stages, and monthly credits representing revenues allocated to Stages. The "bus rental" credits, when added, total \$12,073.76, which is also the figure shown on the revenue and expense statement; the "operating revenues" on this exhibit total \$171,291.84; and the combined total of both equals \$183,365.60 of revenues, as shown on Exhibit C. The debits of "bus rentals" on the exhibit referred to by respondent total \$63,136.92, which represent charges against Stages. On Exhibit C, the corresponding item (shown under transportation expenses, at item 43 as "rent for equipment") is shown, but as \$63,226.92. (No explanation appears for the \$90 discrepancy.) The same exhibit also shows a large item of "rent for equipment" received by Interstate (at item 13 under operating revenues), amounting to \$149,941.37. This of course includes the rental charges against Stages. (The auditor, Hall, testified [48] that the item in favor of Stages designated as "rent for equipment" "represents the use of other companies' equipment—the use of the California Company's equipment on the properties of the other lines," and that "equipment rental which is shown here as being earned by the Nebraska Company [petitioner] is the rent of

If the expenses, which total \$211,470.57, are reduced by the "bus rental" item (or "rent for equipment," as it is termed in Exhibit C, which is shown on that exhibit as being \$63,226.92),<sup>1</sup> automatically there must be eliminated the same amount from Interstate's gross income. The other expenses shown on the revenue and expense statement all appear to be out of pocket expenses actually paid by Interstate. None of them appears to be of a character that is non-deductible. The elimination of this accounting charge against Stages and of the corresponding credit to Interstate would have the arithmetical result of altering the deficit figure and converting it to a profit, but it also automatically would reduce Interstate's gross income by the same amount, and so would not affect the net result. No question has been made heretofore of the propriety of the accounting allocations as between the two companies. While Stages' expenses should not be inflated by a unilateral charge representing, what would, in respondent's language, "simply be a transfer from the taxpayer's right hand to its left," (Brief, p. 12) this is no such case. Here the charge is reflected by a corresponding increase in

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Nebraska cars operated in California and Illinois territory." The inference is plain that the \$63,136.92 (or \$63,226.92, whichever is right) is included as a part of the \$149,941.37 shown as an operating revenue item of Interstate; and that the \$12,073.76 of "rent for equipment" nominally credited to Stages is correspondingly reflected as a charge against Interstate (at item 43). The net result is of course that the \$12,073.76 of bus rentals "received" by Stages (and included in the \$183,365.60 of revenues) and the \$63,136.92 (or \$63,226.92) of similar rentals "paid" by Stages and included in the \$211,470.59 of expenses shown on Exhibit C were respectively reflected as expenses and receipts of Interstate.

1. The figure is badly blurred in some of the copies attached to the transcript, but it can be demonstrated by reference to the original record and by arithmetic that the figure is \$63,226.92.

Interstate's gross income. The parties have tried the cause on the theory<sup>1</sup> that the deficit, of which "bus rental" constituted an item, was properly computed. The respondent's answer specifically admits (13) the allegation of sub-paragraph 7 of paragraph V of the petition (5) that the deficit amounted to \$28,100.66. If respondent's argument in this respect at this stage of the litigation has any validity, it at most should call for a remand to the Board for further findings and if necessary further evidence. *Helvering v. Wood*, 309 U. S. 344, 60 S. Ct. 551, 84 L. Ed. 796.

### **Discussion of Respondent's Argument Concerning the Agency Relationship.**

Respondent, (Brief, p. 14) stresses the necessity of organizing Stages to obtain the permit for intrastate operation. He ignores completely the fact that in 1936 there was no legal obstacle to direct operation by Interstate of the local business. He makes the assertion (*ibid*) that "had the application been made by Stages as agent for the taxpayer the permit would not have been granted;" but the only requirement of local law as construed by the Commission was that the certificate must run to a domestic company. The operation in California was a part of Interstate's business enterprise. Respondent at the outset of his argument (Brief, p. 8) concedes the "business necessity." This in effect is saying that the expense was

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1. In *Helvering v. Wood*, the following appears in the opinion: "For a wholly different reason, petitioner's (the Commissioner) argument based on § 22 (a) must fail. The Board of Tax Appeals purported to place its decision solely on § 166 and § 167 of the Act. Petitioner in his assignments of error specifically mentioned only § 166 and § 167 not § 22 (a). In his brief before the Circuit Court of Appeals petitioner expressly waived reliance upon any section other than § 166. Though petitioner in his petition for certiorari relied on § 22 (a), respondent in oppo-

"necessary." Interstate, in the ordinary course of its business, was engaged in bus transportation of which the California interstate operation had been a part ever since the trans-continental operation commenced. The limited intrastate business was of the same general nature and a part of the operation, as a whole, of a complete integrated bus transportation business. Accordingly, the expense was "ordinary" as well and was an expense of petitioner's business. Certainly this is true as to the interstate portion of it, which accounted for all of the expense, a circumstance which is also ignored by respondent, although accepted as a fact by the court below (75).

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sition thereto took the position that that point was not available to petitioner here as it was not raised below. In view of these facts, especially the express waiver below, we do not think that petitioner should be allowed to add here for the first time another string to his bow. As we have indicated, the issues under § 166 and § 22 (a) are not coterminous. Though both deal with concepts of ownership, the range of inquiry under the latter is broad, under the former confined. To open here for the first time and in face of the express disclaimer an inquiry into the broader field is not only to deprive this Court of the assistance of a decision below but to permit a shift to ground which the taxpayer had every reason to think was abandoned in the earlier stages of this litigation."

While in the present case there was no affirmative "disclaimer" of the point now advanced, yet the respondent's brief in the court below recognizes the deductibility, in general, of the expense items and treats the deficit as a true operating deficit. The brief contains no hint of his present argument on this point, nor did either opinion below make the slightest reference to it.

Elsewhere in his argument (Brief, p. 30) respondent makes the assertion that "the business of the taxpayer included neither interstate nor intrastate carriage in California." This assertion is in direct conflict with his own admission (13) that petitioner during 1936 "was engaged in the operation of motor buses for the transportation of passengers between Chicago, Illinois, and Los Angeles, California." It is also in conflict with the assumption made by the court below (75) that Stages was "an agent of the petitioner as a carrier of its interstate traffic in California." In spite of the pleadings, in spite of the close integration of the parties (which alone has in many cases been sufficient to establish the fact of agency), in spite of express recitals in the absorption contract (57) that the operations were conducted "solely for the benefit" of Interstate (language which when construed in the light of the surrounding facts and circumstances merely states in different words the concept of an agency relationship), respondent either ignores these realities, or treats them as of no significance. Where the interests of the parties are reversed, respondent customarily stresses the realities, and the necessity of stern dealing with tax avoidance schemes, as he did in *Higgins v. Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, and *Burnet v. Commonwealth Improvement Company*,

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1. Paragraph V, subparagraph 4 (5) of the petition alleges that "since 1932 petitioner's California business, both intrastate and interstate, has been conducted by the Stages Company and petitioner has done no business in California." This allegation read together with subparagraph 2 (4) amounts in effect to saying that Interstate's California business was conducted by Stages. Respondent denied this allegation (13) but admitted (13) the allegation of subparagraph (2) that petitioner was engaged in the operation of buses between Chicago and Los Angeles. The pleadings therefore establish the direct contrary of what respondent has asserted (quoted in the text above).

287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399.<sup>1</sup> Here, however, he avoids any attempt to support his position on the basis of reality, seeks to extend the doctrine of cases aimed at tax avoidance to this case, in which no such question is present, and, with an emphasis on form instead of substance that he justly rejects when it is the taxpayer who urges it, asserts (Brief, p. 15) that "the taxpayer cannot now disavow the former's (Stages') separate existence or legal responsibility." It is not the taxpayer that is disavowing Stages' separate existence. Stages' separate existence is consistent with its position as a mere agent or instrumentality of Interstate. It is respondent who is insisting on disregard of actualities; for he would disregard the facts evidencing Stages' agency, and even disavow his own formal admissions in the pleadings, and by rejecting the actualities would deny to Interstate a deduction of a part of the actual cost of carrying on its business.<sup>2</sup>

### **Respondent's Treatment of *Southern Pacific Co. v. Lowe*, and *Gulf Oil Corporation v. Lewellyn*.**

Respondent attempts to distinguish *Southern Pacific Co. v. Lowe* and the *Gulf Oil Corporation* case (248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133) by urging that they were concerned with the question of pre-1913 versus post-1913 earnings. Yet he concedes (Brief, p. 17) that the

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1. Respondent's policy of attempting to extend the principle of such cases, which turn largely upon the question of tax avoidance devices, is in striking contrast to the emphasis he placed on this aspect of *Higgins v. Smith*. Excerpts from his brief in that case which illustrate that emphasis are set out below in the Appendix p. 24).

2. He also, in denying the significance of the absorption contract as one for an agency relationship, refuses himself to accept the full significance of his own contention that Stages' separate entity should be respected. *Infra*, p. 13.



decision in those cases "was that the taxpayer's relation to their wholly owned subsidiaries was such that the income accrued to the former before the 1913 tax date." Pre-1913 income was not taxable; but that circumstance had nothing to do with the question whether or not it was the parent's income, nor whether or not the subsidiary was the parent's agent. The considerations which led to the conclusion that the pre-1913 income had already come into the parent's hands are the same as those here urged on petitioner's behalf. Under respondent's argument the Central Pacific's pre-1913 income continued to be its, not Southern Pacific's, income on March 1, 1913. This, if true, would have subjected a dividend out of that income to tax, as this court held in *Lynch v. Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, a case ignored by respondent but which demonstrates that it was not the fact that Central Pacific had earned the income before 1913 that was significant; it was the "peculiar circumstances," which before the dividend was declared and before March 1, 1913 made this income for all practical purposes that of Southern Pacific, that led to the result. Courts which have cited these two cases in support of the agency doctrine have not attached any significance to the supposed distinction because the earning of the income antedated 1913. Nor does respondent do so when this suits his purpose.<sup>1</sup>

Respondent in this connection refers (Brief, p. 18) to the identification of wholly owned corporations with their owners as something to be done for tax purposes only

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1. In his brief in this Court in *Higgins v. Smith*, he twice cites these same cases for the proposition urged herein by petitioner. See Appendix, *infra*, p. 23. Except for the fact that the present is a converse case, the quoted excerpts are equally pertinent here.

"when required to effectuate an expressed Congressional policy." The policy expressed in section 13 of the statute is that every corporation be taxed on no more than its true net income. If the fact of a subsidiary's agency for its parent exists, that fact should, to effectuate that policy, be recognized just as in the case of any agent.

**Reply to Respondent's Discussion of Question Whether Payment of Subsidiary's Loss Is Ordinary and Necessary Expense.**

Respondent, under Point II, contends, in effect, that the contractual arrangement between parent and subsidiary should be disregarded because of the close relationship, and therefore that the obligation of the contract be ignored. This contention is in harmony with respondent's general philosophy of "regarding" the entity when it

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1. Respondent distinguishes *Inland Development Company v. Commissioner*, 120 Fed. (2d) 986, on the ground of this argument based on "Congressional policy." There the Congressional policy was aimed at preventing tax avoidance by personal holding companies. The taxpayer was literally within the definition of such a company if a certain so-called "dividend" from a subsidiary were included in its income. The interrelation was substantially like the one in the present case. The court there accepted the taxpayer's contention that the so-called "dividend" was not in fact a dividend. In no substantial respect can the case be distinguished from the present one, unless by the circumstance that Interstate had at one time (but not in 1936) been unable to carry on intrastate operations directly. Giving effect to such a distinction would exaggerate the importance of the limited California intrastate business and ignore the insignificance of the expenses allocable to that business; and in any event the payment was none the less a business expense because it was for what the foreign corporation validly contracted to have done in another jurisdiction, but which had to be performed for it by a local resident acting in its interest. (See our original brief, page 22.)

increases taxes but of "disregarding" it when it operates the other way. If that is the law, then a further hazard is added to the conduct of business. Proper and lawful business arrangements involving subsidiaries would under respondent's philosophy expose a business enterprise to the ever present danger of having one corporate entity rule applied in the case of profits, and another in case of loss. Here, however, to sustain the tax, respondent inconsistently invokes both rules in the same connection. He says (Brief, p. 24) that "the contention that an accrual for a business expense can be taken on the basis of a contractual obligation to make up Stages' deficits must rest on recognition that Stages is an entity separate and distinct from the taxpayer for tax purposes," but then immediately says (Brief, p. 25) that it "is certainly not the sort of an arrangement the taxpayer would have made with an independent carrier," and that the stock in Stages "would have been worthless to anyone other than the taxpayer;" and shortly thereafter he asserts that the contract "is one pervaded by the stockholder-corporate relation." A little farther on (Brief, p. 27) he says that "the fact of the stockholder-corporate relation is the dominant characteristic and certainly the only adequate explanation for a contract of the sort here presented." This is stating in different language that the effect should be materially discounted because it is between a stockholder and a controlled corporation.

As a matter of fact the contract emphasizes the agency relationship. It was in essence, at least as to the interstate business, an agency contract.<sup>1</sup> It is by no means

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1. Respondent refers to the Board's observation (18) that the evidence did not disclose what portion of the loss was attributable to this intrastate operation. This, as pointed out in our original brief (page 4, footnote 1) is incorrect.

inconceivable that such a contract might be made between independent corporations. Corporation A might well desire that a certain operation appropriate to its business be carried on by corporation B, and as a price for guaranteeing B against loss might obtain the right to B's profits. One conceivable motive for B's entering into such an arrangement might exist if B were dominated by an individual who would thereby be enabled to obtain a salary, or whose salary would be better secured under such an arrangement. Notwithstanding respondent's suggestion that such a contract might be worthless to A if A were not B's parent, A might have a very definite motive for such a contract. Arrangements of this sort between independent parties are not so anomalous as respondent suggests. All sorts of individual contractual situations exist in the business world. There is no occasion for speculation as to motives which enter into the making of the myriad contractual relationships of economic life. Plainly such an arrangement between independent individuals would be given effect for tax purposes. Such a situation would not be one for contributing to the capital of a corporation, but an expense occasioned in the course of business operations. Yet here, merely because of the close relationship, it is argued that the arrangement should be disregarded. Here again the argument proves too much. The *bona fides* of the contract are not challenged. There is no question of fraud. Disregard of the contractual relations can be justified, if at all, only on the ground that Interstate's domination of Stages is so complete as to make the latter but an agent or instrumentality of the former. Conversely, if the integration of the parties is not sufficiently close to bring the case within *Southern Pacific Co. v. Lowe*, and other similar authorities, such for instance as the *Inland Development Company*

case, 120 Fed. (2d) 986, or if the reasoning of those cases is now to be rejected, then respect must be accorded a contract between legal entities as to which there is no claim of any fraud, irregularity, or even mistake, under which one entity performs an operating service for another. The stockholder-corporation relationship does not, standing alone, convert a payment otherwise an expense into a capital contribution.

Just what is meant by respondent in saying (Brief, p. 25) that the nature of payments to Stages is shown "by the fact that they were not measured by its expenses or losses incurred in serving the taxpayer, i.e., by coordinating their schedules," is not clear. The contract recites (57) the purpose to give Interstate the greatest benefit from operation and to arrange for coordinated operation. The formal promise of Stages is to operate buses upon routes and schedules directed by Interstate. The latter agrees to reimburse the former for deficits and the former agrees to pay the latter any profits. Respondent repeats (Brief, p. 26) the assertion that the deficit did not result from this synchronizing service, and asserts further (*ibid*) that "the net loss, rather, was in general one resulting from all Stages' operation in intra and interstate as well." Even if true, this argument is beside the point. As a matter of fact the loss was incurred in the interstate operation (as the court below assumed). What intrastate revenue there was reduced the loss.

An additional significance of the contract is that its provisions meet the criticism of certain authorities which have in similar situations denied relief because the payment has been "voluntary." *National Piano Mfg. Co. v. Burnet*, 50 Fed. (2d) 316; *Robinson v. Commissioner*, 53 Fed. (2d) 810, 79 A. L. R. 975.

Respondent cites some lower court decisions (Brief, p. 26) for the general proposition that a contribution by a stockholder to replenish a corporation's impaired capital must be treated as a capital expenditure. This general proposition does not reach the facts of a case like this, where the activity producing the year's deficit results from an excess of expenditures over receipts in the conduct of an operation normal to the taxpayer's regular business. If lower court decisions are to be cited in connection with a question that has not previously been decided by this court, the reasoning of and decision in *Wiggin v. Commissioner*, 46 Fed. (2d) 743, supports petitioner.

In the same connection respondent says (Brief, p. 29) that "business expenses must be allocated so as to be the expense of the parent or the subsidiary and not the expense of both." This is undoubtedly correct; but the form of statement is misleading and suggests that if petitioner is upheld a duplicate deduction will result in the form of a tax benefit to both entities. Such is not the fact; and respondent may not have intended to convey this impression. Following this observation respondent refers (*ibid*) to the general proposition that losses of the taxpayer are not to be taken by another, even where there is a close relationship, a proposition that may generally be conceded. For this he cites four cases, three<sup>1</sup> of which were discussed in our original brief. Two of these involved tax avoidance schemes, and one a successor entity clearly not an agency, besides also involving a temporary change of control. The fourth, *Burnet v. Clark*, 287 U. S. 410, 53 S. Ct. 207, 77 L. Ed. 397, involved a

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1. *New Colonial Ice Company v. Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348; *Dalton v. Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389; *Burnet v. Commonwealth Improvement*, 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399.

majority stockholder of a dredging company. He endorsed its notes and later paid them and was allowed loss deductions. He sought to carry forward the losses, under the carry over provision relating to losses in the operation from a trade or business. He was not in the investment business. The case is like *Dalton v. Bowers*, and no more in point here than that case.

The only other decisions of this Court that respondent cites are *Welch v. Helvering*, 290 U. S. 111, 54 S. Ct. 490, 78 L. Ed. 212, already discussed in our original brief (on page 25), and *Deputy v. DuPont*, 308 U. S. 488, 60 S. Ct. 363, 84 L. Ed. 416, which is clearly not in point, if for no other reason than the circumstances that the taxpayer owned only sixteen per cent of the stock, and that the transaction was of an unusual, not an ordinary, nature. Respondent also cites the English decision reported as *Odham's Press, Ltd. v. Cook*, 56 Times Law Reports 704,<sup>1</sup> and *Walker v. Gulf & Interstate Ry.*, 269

1. In the *Odham's Press* case the taxpayer, a printing concern, acquired the stock of "Coming Fashions, Limited," which latter company published the periodical "Everywoman's." The Lord Chancellor's statement of the facts recites that the taxpayer acquired the shares partly to secure work for itself in printing this periodical, and that it was also hoped that the subsidiary, which had been profitable, "would again become a going concern." Accordingly, as he says, the taxpayer was interested in it as a shareholder and hoped to receive dividends, and also "as printers who did work for it at full trade prices." Viscount Maugham's opinion makes it clear that the taxpayer was a creditor of the subsidiary for work done, and that, as he says, the relationship of tradesman and customer existed. He further recites that although the taxpayer wrote off so much of the debt of the subsidiary as represented the subsidiary's loss, yet the debt was not released. No such "peculiar circumstances" of close integration were present as the record in the case under review discloses, nor was there any contract relationship between the companies ~~as~~ exists here.

Fed. 885.<sup>1</sup> Neither case is an authority here; but both are distinguishable by the fact that the advances of the parent were treated as loans and carried as assets, neither involved a contractual relationship like that of the present case, and in neither case were the two corporations closely integrated as here. The *Esmond Mills* case, 132 Fed. (2d) 753, involved a parent's payment to a subsidiary of a sum representing an inventory loss of the latter, and of another sum representing what the latter had to pay to obtain cancellation of an unfavorable contract. In denying the parent the deduction of either item, the court ignored its own prior decision in the *Wiggin* case, 43 Fed. (2d) 743, and relied heavily on the decision now under review herein. Also cited was *American Package Corporation v. Commissioner*, 125 Fed. (2d) 413, 140 A. L. R. 642, in which, although the decision on the facts was adverse to the taxpayer in result, the reasoning supports the petitioner.

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1. In the *Walker* case a railroad company, the taxpayer, organized a terminal company, which had separate books and accounts and was managed by a separate set of officers. Its operations were financed by the railroad company, which advanced the terminal company moneys to enable it to meet operating expenses. The Terminal Company never repaid any of such advances. There is no mention in the report of the case of any contract obligation. The sums in question were charged on the railway books "as advances to the Terminal Company and as a debt due by it," and were "so carried on the books of the Terminal Company." (Compare the contrary treatment in the present case on the books of both Interstate and Stages, and the definite contract provision negating any debtor and creditor relationship with respect to

## Reply to Respondent's Suggestion That the Deduction Claimed Was Mere Book Entry.

Respondent at two places toward the end of his argument injects the notion that what is involved is only bookkeeping. Thus he says (Brief, p. 29) that the contract requirement is one "to shoulder the subsidiary's loss via a mere book entry;" and the last sentence of his argument (Brief, p. 32) says that "no arrangements for book entries . . . can defeat the Commissioner's right . . ." It is not clear whether he intends to convey the impression that, somehow, the deduction does not represent a real sustained expense of Interstate. The latter actually paid out the cash payments, which appear to have constituted the entire operating expenses except bus rental. The latter was a proper operating expense item which is offset in the computation of Interstate's net income by the inclusion of the amount of it in gross receipts (*supra*, pp. 5-7). Respondent concedes, and even asserts, (Brief, p. 30) that "the soundness of the allocation method followed is not in issue." Indeed, although he disparages the claimed deduction as a "mere book entry," his whole contention is predicated on bookkeeping allocations between the two companies. The amount of the deficit is conceded. The tribunals below have proceeded on the assumption that the item is a real one, not a "mere book entry." The review here of the legal questions should not be concerned with a fact question, which though lurking in the record, played no part in either tribunal's decision. The accounting entries represent the manner in which the

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deficits and, instead, providing for assumption by taxpayer of this expense burden.) The opinion recites that there was "a loan from the company to another" which was "carried on the books of each company as an advance by one still owed by the other," and the conclusion was reached that the corporate entities could not be disregarded and that what appeared as an advance, and therefore a debt, on the taxpayer-parent's books could not be deducted.

net expense, \$28,100.68, (or difference in Interstate's net income if the bus rental is eliminated on both sides of the account) was reflected on the books.' The accounting was proper and is not challenged. If the entry represents "mere bookkeeping," and is therefore not to be given the effect claimed for it, then under the *Southern Pacific Company* case the entire system of allocation of charges must likewise be disregarded as mere bookkeeping. The result, so far as Interstate's net income is concerned, is the same. In either case it is \$28,180.66 less than respondent contends.

1. Exhibit A shows the ledger account of cash advances and charges for bus rental, and of allocated revenue receipts and bus rental credits. At the beginning of the year Stages had a credit balance of \$67,543.12 (63). This reflects previous years' profits. The 1936 operations resulted in payments and charges of more than was received and credited. At the end of the year the credit balance was \$41,637.22. Accumulated profits of Stages, and under the contract belonging to Interstate, which at the beginning of the year were \$75,612.84 (Exhibit 3, Rec. 61), had at the end of the year been reduced by the year's operating loss of \$28,100.66 to \$47,512.18. This amount represents Stages' indebtedness to Interstate, under the contract, for accumulated profits and was carried as such, but did not reflect the balance, on the ledger account. The difference between the ledger credit balance, at the end of the year (63), \$41,637.22, and the Stages' obligation at the beginning of the year for past profits, \$75,612.84, which is \$33,975.62, represented Stages' obligation before subtraction of the deficit. As between the parties, payment of the deficit was accomplished by entries having the effect of crediting \$28,100.66 against this indebtedness. The result was to reduce it to the difference of the two last named sums, or \$5,874.96. The details are described in Hall's testimony on cross-examination (44 to 55, inclusive) and fully shown on the balance sheet (Exhibit B, 65) and the ledger accounts (Exhibit A, 63). The \$28,100.66 is the net difference in Interstate's 1936 actual income over expenses, or in actual net income, that was occasioned by the California operation.

## CONCLUSION.

Because of the California operation, most of it interstate business, petitioner's actual net income for 1936 was \$28,100.66 less than respondent and the tribunals below have determined. Stages was Interstate's agent in the conduct of that business. Recognition of this fact does not involve disavowal of the separate existence of Stages. Recognition of the entities also involves recognition of their contractual relationship, which was one whereby Stages became Interstate's agent. There is no fraud, attempted evasion of taxes or estoppel against showing the true relationships. Realities support the petitioner. Respondent's contention ignores realities.

Respectfully submitted,

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## APPENDIX.

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Excerpts from respondent's brief in *Higgins v. Smith* on file in this Court.

### A. Excerpts dealing with the agency doctrine:

On pages 17 and 18 of respondent's brief in *Higgins v. Smith* the following appears:

"The decision of the court below exalts form above substance in a way contrary to the purpose of the tax laws. Cf. *Gregory v. Helvering*, 293 U. S. 465, 470; *Minnesota Tea Co. v. Helvering*, 302 U. S. 609, 613-614; *United States v. Phellis*, 257 U. S. 156, 168; *Lucas v. Earl*, 281 U. S. 111, 114; *Southern Pacific Co. v. Lowe*, 247 U. S. 330; *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71."

On pages 28 and 29 of that brief the following appears:

"Our position does not necessarily involve a disregard of the corporate fiction. It may be conceded, as in the *Gregory* case (p. 469), that when Innisfail was organized, a 'valid corporation was created.' And it may further be assumed *arguendo* that technical title actually passed to the corporation in the various sales which respondent undertook to execute to it. The gist of our position is that such 'sales' did not and could not constitute such final dispositions of the securities so as to bring about a 'loss' within the meaning of the statutory provisions. Our contention is therefore not in conflict with the results reached in such cases as *Dalton v. Bowers*, 287 U. S. 404; *Burnet v. Clark*, 287 U. S. 410; *Burnet v. Commonwealth Imp. Co.*, 287 U. S. 415; and *Klein v. Board of Supervisors*, 282 U. S. 19. In those cases, corporations were employed to conduct certain affairs, and this Court held that the taxpayers were bound by the tax conse-

quences which flowed from the use of corporations. The Court there simply refused to disregard the corporate entity where those interested in the enterprise had selected the corporate form and were seeking to avoid the consequences of that choice. The instant case does not require a disregard of the corporate fiction; we merely urge that no deduction is given by Section 23(e) under these circumstances."

"But even if it were necessary to disregard the corporate fiction there is persuasive authority that would justify such a course. In *McCaskill Co. v. United States*, 216 U. S. 504, 515, this Court noted a 'growing tendency' to look beyond the corporate form. See also *United States v. Lehigh Valley R. R. Co.*, 220 U. S. 257, 272-274; *Chicago, M. & St. P. Ry. Co. v. Minn. Civic Assn.*, 247 U. S. 490, 500-501. And in two cases arising under the first of our modern income tax statutes, this Court pierced the corporate veil. *Southern Pacific Co. v. Lowe*, 247 U. S. 330; *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71. In *New Colonial Co. v. Helvering*, 292 U. S. 435, where the taxpayer sought unsuccessfully to disregard the corporate entity, the Court nevertheless plainly stated that (p. 442):

"\* \* \* the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. \* \* \*

"We respectfully submit that the instant case presents just such a situation as was referred to in the *New Colonial Co.* decision, and that *Dalton v. Bowers*, 287 U. S. 404, and like cases are to be assimilated to the *New Colonial Co.* case itself."

B. Excerpts dealing with the importance in the case of tax avoidance:

On page 5 of that brief the following appears:

"2. *Purposes and operations of Innisfail.*—The Innisfail Corporation was formed by taxpayer for the purpose of avoiding inheritance and income taxes (R.

35). At the time he formed the Innisfail Corporation, he had in mind the taxable gain which would accrue from the exchange of Chrysler preferred for Chrysler common (R. 35). And he knew that a corporation would not pay a tax on its income which an individual would have had to pay as a result of the dividend payments on the Chrysler stock contributed by him to Innisfail Corporation (R. 49)."

On page 17 the following appears:

"And where the taxpayer has boldly undertaken to create artificial losses by paper transactions, it is particularly important to keep in mind the recent words of this Court that 'It is in the public interest that no one should be permitted to avoid his just share of the tax burden except by positive command of law.'"

On page 19 the following appears:

"The Revenue Act contemplates genuine losses, recognized as such by the business world, not fictitious losses resulting from transfers by the taxpayer to his incorporated pocketbook. Deductible losses might as well be allowed when the taxpayer on his books transfers an investment from one account to another."

On pages 20 and 21 the following appears:

"Innisfail was created and persistently used, with negligible exceptions, for the specific purpose of serving respondent in his efforts to avoid taxes. In the year in question he realized large amounts of income that would ordinarily have been subject to tax unless offset by the phantom sales. While those sales may have been real in the narrow sense that title passed, they were wholly unreal in the sense that respondent never parted nor ever intended to part with his unfettered control over the securities in question.

"Innisfail was obviously not organized for the purpose of trading in the outside business world. The record shows that it was created and used for an

entirely different purpose. The trading was practically all with the taxpayer, who ignored the corporate entity in substantially every transaction he had with it. From the creation of Innisfail until the year in question the taxpayer took all the dividends and cash that came in, ignored the corporation's bank account, and appropriated the funds to his own uses; but at the same time he was able to place the dividends on the books as belonging to the corporation and avoid the surtax that he would have had to pay if he had returned them as his own (R. 44-51)."

On page 22 the following appears:

"A contrary holding would mean that Congress in providing for the deduction of losses *sustained* during the taxable year was nevertheless willing to sanction so obvious a device for circumventing the condition it so carefully spelled out."